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No. 79/37

February 22, 1979

TO COUNTY ASSESSORS:

RESTRICTIONS IN VALUING SECTION 236 HOUSING BY THE INCOME APPROACH

On September 11, 1978 the Governor signed Senate Bill 1706, Chapter 737, which restricts the income to be capitalized when valuing Section 236 federally subsidized properties by the income approach.

The law states the assessor "...shall not consider as income any interest subsidy payments made to a lender on such property by the Federal Government...."

In our opinion, this law is not retroactive; however, under the provisions of Board Rule 461 (January 25, 1979), Section 236 projects whose base year values have been established by the capitalization of an income including subsidy payments should be reappraised as of March 1, 1979 with consideration given to the limitations imposed by Senate Bill 1706. The resultant value should be compared to the full cash value base to determine whether or not a new base year should be established.

The income approach remains the preferred method of valuation for these properties; however, the effect of the capitalization rate upon value and the appropriate method of deriving this rate is a subject that should be given serious consideration. Appropriate yield rates are generally derived via the band-of-investment method because lack of sales data precludes market derivation. In the band-of-investment method, the rate is the weighted average of the different portions of investment. The two major portions are the debt and equity investments and the respective return rate for each. An example of this method applied to a typical 236 limited dividend property when the subsidy is included as income follows:

$$\text{Debt component} \quad .90 \times .07 = .063$$

Equity component $.10 \times .06 = .006$

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|------------|------|
| Yield Rate | .069 |
|------------|------|

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It is axiomatic that a yield rate must be applied to the same level of income from which it was derived. It follows that when the interest subsidy is not considered income, the effective rate of that debt component would be approximately 1 percent because the federal subsidy is based on the interest charges above 1 percent.

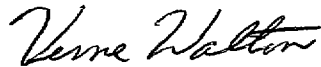
The band-of-investment yield rate would then be as follows:

| | | | | | |
|------------------|-----|---|-----|---|-------------|
| Debt component | .90 | x | .01 | = | .009 |
| Equity component | .10 | x | .06 | = | <u>.006</u> |
| Yield Rate | | | | | .015 |

Market derived rates would contain similar variations.

The use of this yield rate would theoretically compensate for the exclusion of the subsidy income. In no case should the higher yield rate be used to capitalize the income excluding the subsidy. The result would be a distorted market value estimate, and in effect, a portion of the property value would be illegally exempted.

Sincerely,



Verne Walton, Chief
Assessment Standards Division

VW:sk